ST 05-0097-GIL 10/13/2005 USE TAX

This letter concerns the taxability of materials that are damaged in the manufacturing process. See 35 ILCS 105/3-10. (This is a GIL.)

October 13, 2005

Dear Xxxxx:

This letter is in response to your letter dated June 21, 2004, in which you request information. The Department issues two types of letter rulings. Private Letter Rulings ("PLRs") are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. Persons seeking PLRs must comply with the procedures for PLRs found in the Department's regulations at 2 Ill. Adm. Code 1200.110. The purpose of a General Information Letter ("GIL") is to direct taxpayers to Department regulations or other sources of information regarding the topic about which they have inquired. A GIL is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120. You may access our website at www.ILTAX.com to review regulations, letter rulings and other types of information relevant to your inquiry.

The nature of your inquiry and the information you have provided require that we respond with a GIL. In your letter you have stated and made inquiry as follows:

> As counsel for and on behalf of COMPANY, a STATE corporation, we hereby respectfully request, pursuant to 2 Ill. Admin. Code Section 1200.110, a private letter ruling from the Illinois Department of Revenue ('Department'), which confirms that the transaction described below is not subject to the Illinois Use Tax Act ('UTA') and/or Illinois Retailers' Occupation Tax Act ('ROTA').
>
> There is no particular tax period at issue for this ruling request. The Company is not under audit and is not involved in any litigation with the Department. To the best of our knowledge, and to the best of the Company's knowledge, the Department has never ruled on the issues discussed in this request (or on any similar issue) for the Company or its predecessors. In this connection, neither the Company nor any of its representatives has ever submitted this or any similar issue for a ruling by the Department. The Company is unaware of any authority contrary to the views expressed in this request. However, ST 91-0023-PLR supports our argument in finding that material used by a printing company in a cancelled print job constituted waste material and, therefore, was not taxable.[1]

FACTS

Company manufactures gaming devices, including video lottery terminals and video mechanical gaming devices. In order to produce its gaming devices, Company purchases materials under an exemption certificate and does not pay either Use Tax ('UT') or Retailers' Occupation Tax ('ROT') on the purchase of its materials. When purchasing the materials, Company intends to incorporate all of the materials into its manufactured product, which is sold, at wholesale or at retail to final consumers. However, approximately 1% to 2% of the materials are spoiled or damaged in the manufacturing process and are discarded as scrap. The Company does not sell the spoiled or damaged materials as an intentionally produced by-product of its manufacturing process. At the time the spoiled or damaged materials are discarded, they have absolutely no value.

LAW

In general, ROT is imposed upon persons selling tangible personal property at retail. 35 ILCS 120/2. The definition of 'sale at retail' specifically excludes sales for resale 'provided that the property purchased is deemed to be purchased for the purpose of resale, despite first being used, to the extent to which it is resold as an ingredient of an intentionally produced product or by-product of manufacturing.' 35 ILCS 120/1 §1. Illinois' regulation relating to sales of tangible personal property to purchasers for resale reiterates that 'sale at retail' does not include property purchased as an ingredient of an intentionally produced product or by-product of manufacturing. 86 Ill. Admin. Code 130.210(b). That regulation, however, goes on to state that 'except to the extent stated in subsection (b) of this Section, tangible personal property, even though it is essential to the process of manufacturing or otherwise producing other tangible personal property that will be sold is, nevertheless, sold as retail (and not for resale within the meaning of the Act) if it is sold to a manufacturer or other producer who uses or consumes such property in the manufacturing or other production process, but does not physically incorporate such property into the tangible personal property which he manufactures or otherwise produces and sells.' 86 Ill. Admin. Code 130.210(d).

The UT complements the ROT by imposing tax on the privilege of using tangible personal property purchased at retail from a retailer and includes the same exception for tangible personal property that is an ingredient of an intentionally produced product or by-product of manufacturing. 35 ILCS 105/3; 86 Ill. Admin. 150.201. Additionally, 'in all cases where property functionally used or consumed is a by-product or waste product that has been refined, manufactured, or produced from property purchased at retail, then the tax is imposed on the lower of the fair market value, if any, of the specific property so used in this State or on the selling price of the property purchased at retail.' 35 ILCS 105/3-10.

DISCUSSION

In general, under both UTA and ROTA, tangible personal property is exempt as a sale for resale when purchased as an ingredient of an intentionally produced product or by-product of manufacturing. 35 ILCS 120/1 §1; 35 ILCS 105/3; 86 Ill. Admin. 150.201; 86 Ill. Admin. Code 130.210(b). However, to the extent a manufacturer or other producer uses or consumes such property in the manufacturing or other production process, but does not physically incorporate such property into the tangible personal property that is manufactured or produced and then sold, the tangible personal property is taxable. 86 Ill. Admin. Code 130.210(d).

Two cases are instructive in interpreting whether tangible personal property is used or consumed in the manufacturing process rather than as an ingredient in an intentionally produced product or by-product. In Container Corporation of America v. Wagner, 293 Ill. App.3d 1089, 1094 (1st Dist. 1997), the manufacturer purchased base ingredients for inks and lacquers, which were used in fabricating its boxes used to package consumer products. When using inks and lacquers from concentrate, Container Corp. diluted the concentrate with various solvents before applying them to the paperboard to satisfy the specific design and labeling requirements of its customers. Container Corp. argued that the solvents were purchased to make the inks and lacquers and were thereby incorporated into the finished boxes, which were sold to its customers. The court, however, held that the solvents were taxable because Container Corp. had stipulated that the solvents evaporated during the drying process and, therefore, were not incorporated into the intentionally produced product.

In Clark Oil & Refining Corporation v. Johnson, 154 Ill. App. 3d 773, 107 Ill. Dec. 307, 506 N.E.2d 1362 (1987), the manufacturer purchased crude oil for the purpose of refining it into various marketable products. However, three products are invariably produced as a part of the refining process that have no or very little marketability. Those products are catalytic coke, process gas, and heavy oil. Clark Oil burned off the catalytic coke and converted it into flue gas, which it then used as an energy source. However, Clark Oil was unable to use the process gas so it flared the excess process gas, thereby dissipating it. Finally, the heavy oil was both resold in part and used in part by Clark Oil in its refinery's heating needs.

Clark Oil argued that since the catalytic coke and process gas were not sold and had no market value they were not subject to use tax. Justifying its position, Clark Oil relied on the language found in 35 ILCS 105/3-10 that 'in all cases wherein property functionally used or consumed is a by-product or waste product which has been refined, manufactured or produced from property purchased at retail, then the tax is imposed on the lower of the fair market value, if any, of the specific property so used in this State or on the selling price of the property purchased at retail.' (quoting from Clark Oil) The court rejected Clark Oil's argument that Section 3-10 applied because the court determined the section had only prospective application. Instead, the court followed Mobil Oil Corp, v. Johnson, 93 Ill. 2d 126, 442 N.W.2d 846 (1982), which held that 'relative volume' was the appropriate standard to determine the taxable amount.

Clark Oil also argued that the tax was discriminatory because a purchaser-user was taxed on its waste while a purchaser-reseller was not taxed on its waste. The court made a point of noting that Clark Oil was not taxed on its waste, but only on its intentional use of refinery fuels, i.e. the catalytic coke and part of the heavy oil. In addition, the court noted that, had Clark Oil provided proper documentation, it would not have been taxed on 'the amount of process gas which was flared and thus not subject to taxation.'

Company's damaged materials are analogous to Clark Oil's process gas in that the scrap is not consumed and has no fair market value. Unlike the catalytic coke, which was converted into flue gas for Clark Oil's use as an energy source, or Container Corp.'s solvents, Company does not consume the scrap, but rather discards it. As the court in Clark Oil indicated, tax applies only to its intentional use of refinery fuels, not its waste product.

Similarly, the Department has issued two private letter rulings discussing product spoilage, which, although no longer valid, are instructive on this issue. First, ST 91-0023-PLR relates to a printer with wasted materials due to a cancelled print job. In that PLR, the Department states that 'it is the policy of this Department not to impose sales tax, i.e. Retailers' Occupation Tax, Use Tax, or Service Occupation Tax on spoilage of tangible personal property purchased legitimately for resale but is ruined and ultimately disposed of as waste.' Second, ST 93-0295-PLR relates to a company whose customer has provided an exemption letter for its purchased products. The company asks whether it is correct that the products are also tax-exempt for spoilage, among other things. Again, the Department states that 'product that was legitimately purchased for resale but becomes spoilage and is not purchased, does not result in Retailers' Occupation Tax, Use Tax, Service Occupation Tax or Service Use Tax liability.'

Despite the language of 86 Ill. Admin. 130.210(d), existing case law and Department policy indicates that waste products are not subject to either ROT or UT unless used or consumed by the manufacturer in the manufacturing process. The Department has clearly stated that its policy does not include taxing spoilage, which is analogous to Company's damaged materials, even though the tangible personal property was originally purchased for incorporation into its products ultimately sold at retail. Instead, this regulation seems to be aimed at products, such as the catalytic coke discussed in Clark Oil and the solvents discussed in Container Corp., whether the purchaser uses or consumes the excess product in its manufacturing process rather than incorporating the product into intentionally produced product or by-product.

In the alternative, if the Department determines that damaged materials or waste products are taxable under the UT or ROT, Company should not be subject to tax on its scrap because it has no value and is only approximately 1% to 2% of the total materials purchased by Company. First, under the UT, 35 ILCS 105/3-10 states tax is imposed on *the lower of* fair market value or selling price of the property purchased at retail. In this case Company would not owe tax on its damaged material because it has no value. Second, Company's damaged material is de minimis and constitutes spoilage, so 86 Ill. Admin. Code 130.210(d) should not apply.

REQUEST FOR RULING

Pursuant to 2 Ill. Admin. Code Section 1200.110, it is respectfully requested that the Department of Revenue issue a private letter ruling, which confirms that the portion of the Company's purchases of materials which ultimately become scrap and are discarded is not subject to ROT and UT.

If you concur, please issue your favorable ruling to the undersigned. If you do not concur, please advise so that we may discuss your reasoning before an adverse ruling is issued. A Power of Attorney authorizing our representation of the Company is enclosed.

DEPARTMENT'S RESPONSE:

The issue raised in this letter is governed by the provisions of Section 3-10 of the Use Tax Act (35 ILCS 105/3-10). That Section says in relevant part:

> "Unless otherwise provided in this Section, the tax imposed by this Act is at the rate of 6.25% of either the selling price or the fair market value, if any, of the tangible personal property. In all cases where property functionally used or consumed is the same as the property that was purchased at retail, then the tax is imposed on the selling price of the property. In all cases where property functionally used or consumed is a by-product or waste product that has been refined, manufactured, or produced from property purchased at retail, then the tax is imposed on the lower of the fair market value, if any, of the specific property so used in this State or on the selling price of the property purchased at retail."

This Section makes a distinction between "raw materials", part of which become scrap or are spoiled in the production process, and materials that are first refined or otherwise subject to some production process, and then spoiled. The former is subject to a tax on its cost price, the latter is subject to a tax on the lower of its fair market value or cost price. For example, if a manufacturer purchases glass and, before any changes are made to the glass, it breaks and is spoiled, then the tax is imposed on the cost price of that glass. If, however, the manufacturer purchases glass and applies a silk screen to the glass or purchases glass to which a silk-screen has been applied and, in the process of assembling its product, the silk-screened glass breaks, then the tax is imposed on the lower of the fair market value or the cost price of that broken silk-screened glass.[2]

How much, if any, tax is owed in the second instance described in the paragraph above depends on the fair market value, if any, of that broken silk-screened glass. Even if the spoiled or damaged materials have no value to a given manufacturer, they may still have a fair market value. If the manufacturer is not in the business of selling these spoiled materials, the fair market value must be determined by "comparable sales or purchases of property of like kind and character in Illinois." If a manufacturer remits tax based on fair market value, the burden is on the manufacturer to keep in its records information documenting the fair market value of the materials spoiled or damaged, if the fair market value claimed is less than the cost price of those materials.

I hope this information is helpful. If you require additional information, please visit our website at tax.illinois.gov or contact the Department's Taxpayer Information Division at (217) 782-3336. If you are not under audit and you wish to obtain a binding PLR regarding your factual situation, please submit a request conforming to the requirements of 2 Ill. Adm. Code 1200.110 (b).]

Sincerely,

Samuel J. Moore
Associate Counsel

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[1] We recognize that private letters rulings only provide direct benefit to the taxpayer receiving the ruling and expire after 10 years.

[2] This is distinguished from a situation where the glass is cut to size or otherwise deliberately changed in the manufacturing process. In that instance, any "scrap" that results is taxable based on its cost price.